Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

Federal-State Joint Conference on Accounting Issues	)	WC Docket No. 02-269
2000 Biennial Regulatory Review – Comprehensive Review of the Accounting Requirements and ARMIS Reporting Requirements for Incumbent Local Exchange Carriers: Phase II	)	CC Docket No. 00-199
Jurisdictional Separations Reform and Referral to the Federal-State Joint Board	)	CC Docket No. 80-286
Local Competition and Broadband Reporting	)	CC Docket No. 99-301

COMMENTS OF AT&T CORP.

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Pursuant to the Commission's *Notice*,[1] AT&T Corp. submits these comments in support of the recommendations of the Federal-State Joint Conference on Accounting Issues ("Joint Conference") that the Commission retain and strengthen its accounting regulations to ensure that the Commission and state regulatory agencies can effectively carry out their regulatory responsibilities, including their core responsibility to protect ratepayers from anticompetitive behavior on the part of incumbent local exchange carriers ("LECs").

INTRODUCTION AND SUMMARY

The Commission is faced with a stark choice in this proceeding. On the one hand, the Joint Conference has recommended modest but critically important changes to the Commission's

[1] Public Notice, *Federal-State Joint Conference On Accounting Issues*, WC Docket No. 02-269, et al., FCC 03-326 (rel. Dec. 23, 2003) ("*Notice*") (published in 68 Fed. Reg. 75478 (Dec. 31, 2003).

accounting rules and reporting requirements that are the minimum refinements necessary to ensure that accounting information and data maintained and filed by the incumbent LECs is "adequate, truthful, and thorough."[2] On the other hand, the Bell Operating Companies have recently asserted that the data that the Commission collects through its accounting rules and filed by incumbent LECs in ARMIS reports are "obsolete," "unreliable," and "economically irrational."[3] According to the Bells, therefore, the Commission should not merely decline to adopt the modest changes suggested by the Joint Conference, but should eliminate its regulatory accounting rules and reporting requirements altogether.[4]

The only appropriate response to the record is for the Commission to reject the Bells' sweeping claims and adopt the recommendations of the Joint Conference. It is undisputed that the incumbent LECs remain the dominant providers of local services within their service territories, and that they retain significant incentives and ability to discriminate and misallocate costs. *See Joint Conf. Recommendation* at 24 (an ILEC can benefit by "making its regulated earnings appear as low as possible, such as when it is pursuing a takings claim, seeking regulatory relief based on allegedly depressed earnings, or is subject to a profit-sharing requirement"). To detect and deter such misconduct, it is essential that carriers accurately record costs and revenues, and that such regulatory accounting records are disclosed to regulators and competitors that monitor the incumbents' conduct.

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[2] Recommendation by Joint Conference, *Federal-State Joint Conference On Accounting Issues*, WC Docket No. 02-269, at 3 (Oct. 9, 2003) ("*Joint Conf. Recommendation*") (App. A to *Notice*).

[3] *See* Response of Intervenors [BellSouth, Qwest, SBC and Verizon] at 13-14, *In Re AT&T Corp., et al.*, No. 03-1397 (D.C. Cir. filed Jan. 9, 2004).

[4] *E.g.*, Verizon Comments at 3-5, WC Docket No. 02-269, filed Jan. 31, 2003; SBC Comments at 2-4, WC Docket No. 02-269, filed Jan. 31, 2003; BellSouth at 3-4, WC Docket No. 02-269, filed Jan. 31, 2003.

Thus, as detailed below, the Commission should now take a number of steps to strengthen existing accounting and reporting requirements and, in a few instances, to reinstate requirements that were recently repealed. At a time when most of the country's lawmakers and regulators are pursuing a variety of actions designed to strengthen accounting requirements to ensure that large corporations are subject to appropriate accounting and auditing controls (*e.g.*, the Sarbanes-Oxley Act), it would be truly remarkable for the Commission to take the diametrically opposite path and *relax* critically important accounting safeguards in the telecommunications industry.

Part I of these comments addresses the purpose of regulatory accounting requirements and the Commission's authority to impose such requirements under the Communications Act ("Act"). Regulatory accounting and reporting requirements serve multiple purposes. Disaggregated and precisely-defined record-keeping and reporting requirements are necessary to protect consumers and competition against discrimination, cross-subsidization, and other market power abuse by dominant carriers, to allow the Commission to implement effectively the Act's universal service requirements, and to ensure that price cap and other regulation of interstate services protects consumers from unjust and unreasonable rates and practices. Regulatory accounting requirements also permit states to carry out their equally important regulatory responsibilities. But record-keeping and reporting requirements can serve those vital roles only if carriers are required to report relevant accounting data in a sufficiently disaggregated, structured, and accessible form that allows regulators to distinguish among services, affiliates and different types of expenses, revenues, assets and liabilities.

That is precisely why the Act directs the Commission to adopt a uniform system of regulatory accounts, 47 U.S.C. § 220, and provides the Commission broad discretion to require other regulatory accounting and reporting standards to implement the goals of the Act, including the authority to adopt accounting regulations that are used primarily – or even exclusively – by states. Congress contemplated a *uniform* system of accounts that would address both federal and state needs in regulating networks used to provide both interstate and intrastate services. Moreover, because the Commission's accounting and reporting requirements continue to play an extremely important role in protecting the public interest in the face of enduring local bottlenecks, the Act's biennial review requirement, 47 U.S.C. § 161 ("section 11"), which could be triggered in this context only if there were sufficient "meaningful economic competition" to make a particular accounting requirement no longer "necessary in the public interest," *id*., never comes into play.

Part II of these Comments explains why the specific recommendations of the Joint Conference should be adopted. Specifically, the Commission should expand (or reinstate) a number of regulatory accounts to reflect changes in the market and expanded broadband deployment. The Commission should also adopt the Joint Conference's recommendations to strengthen the affiliate transaction rules. These rules are even more important now that all of the Bells have been permitted to offer long distance services through separate affiliates, and the Joint Conference's recommendations eliminate loopholes in the current rules and adopt other protections that prevent incumbent LECs from harming consumers. Finally, the Commission should adopt the Joint Conference's recommendations regarding reporting requirements, which will ensure that data are available to the public in appropriate form. These recommended requirements remain vital to ensuring that the Commission and states are able to carry out their core regulatory responsibilities. Furthermore, these requirements do not impose any undue burden on the dominant LECs.

I. ROBUST REGULATORY ACCOUNTING MEASURES ARE ESSENTIAL MEASURES TO ENSURE THAT COMPETITIVE TELECOMMUNICATIONS MARKETS EMERGE.

1. Purpose of Regulatory Accounting. A primary purpose of regulatory accounting requirements is to protect consumers and competition against exercises of market power. Incumbent LECs retain exclusive control over local bottleneck facilities that are essential to the provision of most telecommunications services. It is the "fundamental postulate underlying modern U.S. telecommunications law" that the incumbent LECs "have both the incentive and ability to discriminate against competitors in [all] retail markets" until their monopoly local telephone markets become fully competitive.[5] Effective regulatory accounting and reporting requirements provide the Commission and state regulators with information necessary to design regulations that deter such anticompetitive conduct, and to monitor and audit the incumbents' compliance with such regulations and other safeguards that check abuse of market power.

Regulatory accounting and reporting requirements are more important today than ever before. New technologies and deregulation have allowed incumbent LECs increasingly to enter competitive markets – *e.g.,* long-distance, wireless and broadband markets – creating additional opportunities for incumbents to abuse their control over the bottleneck local facilities that are necessary inputs in those other markets. And it is only through detailed and strictly enforced accounting and reporting requirements, accompanied by rigorous audits, that the Commission and state regulators can enforce prohibitions against anticompetitive abuses of market power.

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[5] *Applications Of Ameritech Corp. And SBC Communications Inc., For Consent To Transfer Control*, 14 FCC Rcd. 14712, ¶¶ 12, 190 (1999) ("*SBC-Ameritech Merger Order*"). *See also id.* ¶ 14; *United States* v. *Western Elec. Co.*, 969 F.2d 1231, 1238 (D.C. Cir. 1992) (MFJ reflected recognition that "a corporation that enjoyed a monopoly on local calls would ineluctably leverage that bottleneck control in the interexchange (long distance) market"); *United States* v. *American Tel. & Tel. Co.*, 552 F. Supp. 131, 188 (D.D.C. 1982) (same).

Unlike financial accounting requirements, which often authorize highly aggregated data collection and reporting, the Commission's regulatory accounting rules are designed to detect anticompetitive activities, such as discrimination and cross-subsidization of rates in competitive markets with profits from non-competitive markets. Additionally, federal regulatory accounting and reporting requirements are designed to monitor changes to and growth of the industry and of network capabilities, information that goes well beyond the financial concerns that motivate financial accounting records. Monitoring competition and the nature of the industry requires highly specialized and disaggregated data collection and reporting.

Moreover, as the Commission and states seek to minimize regulation and maximize competition in the telecommunications industry, they need sufficient information to develop pro-competitive policies and to assess whether those policies are working. The information contained in the dominant carriers' regulatory accounts is often the only source of such information.

Regulatory accounts are instrumental in assessing whether policies based on predictive judgments are consistent with reality. For instance, in 1999 the Commission predicted that facilities-based competition for special access service would be sufficient to discipline the Bells' exercise of market power over those facilities.[6] Based on this prediction, the Commission substantially deregulated the prices that the Bells are permitted to charge for special access services. The regulatory accounts, however, confirm that the Commission's initial predictions were wrong – there is not sufficient facilities-based competition to prevent the Bells from exercising market power over those services. The Bells' ARMIS data show that the Bells' special access returns have increased rapidly while the Bells' per line costs of providing special

[6] Fifth Report and Order and Further Notice of Proposed Rulemaking, *Access Charge Reform, et al.*, 14 FCC Rcd. 14221 (1999).

access service are rapidly *declining*.[7]

Past Commission proceedings consistently illustrate the usefulness of the existing regulatory accounts for protecting competition. For example, the Commission relied on the incumbent LECs' regulatory accounts to thwart an attempt by those LECs to obtain unwarranted deregulation that could have imposed hundreds of millions of dollars of costs on their access customers (who also happen to be their competitors). Riding the wave of the WorldCom bankruptcy, these incumbents complained to the Commission that they faced increased risk of non-payment for access services by interexchange carriers, and requested that the Commission allow them virtually unfettered discretion to collect massive "security" deposits from their access customers. A central issue in that proceeding was whether the Bells actually faced substantial increased risks of non-payment of access bills. The Bells' regulatory accounts held the answers. Those accounts showed that the Bells' claims of vastly increased payment defaults by IXCs were greatly exaggerated, and that overhaul of tariff deposit requirements was entirely unnecessary, and contrary to the public interest.[8]

Even aside from protecting consumers and competition from the exercise of market power, the Commission's regulatory accounts serve other important functions. For example, the Commission's regulatory accounts are used to administer the Commission's universal service program. The regulatory accounts also provide the Commission with information needed to ensure that incumbent local exchange carriers are charging "just and reasonable" rates for

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[7] *See* Petition of AT&T, *Petition for Rulemaking To Reform Regulation Of ILEC Rates For Interstate Special Access Services*, RM-10593 (filed Oct. 15, 2002); AT&T Reply Comments, RM-10593 (filed Jan. 23, 2003); Petition of AT&T, et al., *In re AT&T Corp.*, No. 03-1397 (D.C. Cir. filed Nov. 5, 2003).

[8] *See* Policy Statement, *Verizon Petition for Emergency Declaratory and Other Relief*, 17 FCC Rcd. 26884, ¶¶ 18-21 (2002).

interstate services. And the regulatory accounts are used by the Commission to implement the price cap mechanism.[9] This fact demonstrates that there can be no merit to the claims of the Bells that the existence of price caps justifies the elimination of regulatory accounting requirements. As AT&T has explained and as the Joint Conference confirms (*Joint Conf. Recommendations* at 24), large incumbent LECs retain significant incentives to misallocate costs under a price cap regime, which does nothing to reduce a LEC's *ability* to misallocate costs.[10] Regulatory accounting rules complement price cap regulation by aiding regulators in detecting and deterring the incumbents' abilities to shift costs. For these reasons, the Commission has consistently determined that "interstate price cap regulation does *not* eliminate the need for cost allocation rules."[11]

2. Federal and State Roles In Collecting Regulatory Accounting Data. Like federal regulators, state regulators also rely heavily on federal record-keeping and reporting data to carry out their responsibilities under the Act, including setting intrastate rates, enforcing affiliate transaction rules, and implementing cost-based wholesale rates.[12] As the Joint Conference

[9] *See* Report and Order in CC Docket Nos. 00-199, 97-212, and 80-286; Further Notice of Proposed Rulemaking in CC Docket Nos. 00-199, 99-301, and 80-286, *2000 Biennial Regulatory Review – Comprehensive Review of Accounting Requirements and ARMIS Reporting Requirements for Incumbent Local Exchange Carriers: Phase 2*, 16 FCC Rcd. 19911, ¶¶ 10-12 (2001) ("*Phase II Order*").

[10] *See*, *e.g.*, Reply Comments of AT&T, Part I.B, WC Docket No. 03-173 (filed Jan. 30, 2004); *Verizon Communications* v. *FCC*, 535 U.S. 467, 487 (2002) (price caps "do not eliminate gamesmanship").

[11] *Accounting Safeguards Order*, 11 FCC Rcd. 17539, ¶¶ 58, 271 (1996) (emphasis added).

[12] *See, e.g., Phase II Order* ¶ 20 ("[T]he Commission has developed an accounting system that almost every state uses. . . . For example, the State of Alaska uses [the accounts] . . . to determine local service rates as well as for evaluating unbundled network element[s]. . . . Alaska also uses the [accounts] to determine intrastate access charges, evaluate the allocation of Alaska Universal Service Fund support, and evaluate proposed tariffs.").

confirms, *Joint Conf. Recommendation* at 8, the importance of these data to state commissions cannot be overstated. For example, implementing the Act's cost-based pricing requirements for unbundled network elements requires states to develop cost studies that estimate forward-looking costs of various telecommunications services. And virtually all such cost studies – including the Commission's own universal service cost model – rely on the Bells' ARMIS data for vital inputs. The ARMIS data currently are the only source of *uniform* embedded cost data that allows both the Commission and states to identify the Bells' costs in their respective jurisdictions. Without the type of uniform accounting data contained in the ARMIS reports, each state would have to design its own record-keeping and reporting requirements in order to wrestle the necessary information away from the Bells. Obviously, that would be extremely burdensome, both to state commissions and to the Bells.[13]

Congress plainly contemplated that the Commission, after conferring with states, would be responsible for establishing the uniform minimum standards for accounting and other reporting requirements. The Act expressly requires the Commission to "prescribe a uniform system of accounts" and further permits the Commission to "prescribe the forms of any and all accounts, records, and memoranda to be kept by carriers subject to [the Act.]" 47 U.S.C. § 220(a)(i). And "[t]he Commission, before prescribing any requirements as to accounts, records, or memoranda, shall notify each State commission having jurisdiction with respect to any carrier involved, and shall give reasonable opportunity to each such commission to present its views, and shall receive and consider such views and recommendations." *Id.* § 220(i).

[13] The Commission also has explained that uniformity of accounting requirements "provides efficiency to the regulatory process for both federal and state regulators because regulators need only have expertise in one accounting system" and that "[u]niformity among states allows regulators or other interested parties to compare and benchmark the costs and rates of incumbent carriers operating in various states." *Phase II Order* ¶ 21.

Moreover, Congress clearly intended for the Commission, not the states, to ensure the accuracy and reliability of those accounts. The Act provides the Commission with monitoring and enforcement mechanisms for failure to maintain properly accounting records in the manner required by the Commission. *Id.* §§ 220(c)-(g).

It is clear, therefore, that the Act does *not* preclude the Commission from implementing regulatory accounting measures that primarily, or even solely, benefit the states. On the contrary, the fact that Congress *requires* the Commission to consult with states when adopting regulatory accounting standards confirms that Congress intended the Commission to implement regulations that are important to both, or either, the states and the Commission in carrying out their regulatory responsibilities. This makes sense. Absent a uniform federally-mandated system of accounts, each state would be left to implement its own accounting reporting requirements in order to carry out its obligations under the Act. But that approach would be unworkable because it would result in as many as 50 different sets of accounting regulatory requirements with which carriers must comply. Obviously, such a system would be extremely burdensome to states and carriers.

Further, section 11 of the Act, 47 U.S.C. § 161, in no way requires the Commission to eliminate accounts that are used solely by the states. As noted, the Commission clearly has authority to implement accounting requirements that are used solely by the states to implement the goals of the Act. 47 U.S.C. § 220(a)(1) ("The Commission may, *in its discretion*, prescribe the forms of any and all accounts, records, and memoranda to be kept by carriers subject to this [Act]") (emphasis added). Section 11 requires the Commission to repeal or modify rules only if two conditions are present: (1) the Commission finds that there exists "meaningful economic competition" and (2) the Commission finds that "as a result" of that "meaningful economic competition" the existing regulation is "no longer necessary in the public interest." 47 U.S.C. § 161(a)(2). The fact that a particular regulatory account is used only by states obviously does not mean that these conditions are satisfied. On the contrary, the section 11 inquiry is a fact intensive task that will depend on the particular account being analyzed and the particular economic market that the data is used to regulate. The section 11 inquiry has little, if anything, to do with whether state or federal regulators are using that data to carry out their respective responsibilities under the Act.[14]

This analysis is confirmed by the Joint Conference, which, after review of the Biennial Review standard and the Commission's authority under section 220, concluded that "the Commission may adopt accounting requirements to meet the needs of the states and other stakeholders," such as recent entrants to local markets. *See Joint Conf. Recommendation* at 6-8. The Joint Conference acknowledged that, as described above, it is "more burdensome to require fifty or more potentially different accounting requirements as opposed to collecting data at a national level." *Id.* The Joint Conference also concluded that state regulatory accounting requirements – which may be limited only to intrastate services – provide only "limited" data that would make it "very difficult to accurately measure the financial health of the carriers." *Id.* For the reasons provided by the Joint Conference as well, the Commission should plainly

[14] In all events, a proper Section 11 inquiry shows that the Commission's regulatory accounts – including those used only by states – should not be repealed or modified. The regulatory accounting requirements serve numerous purposes, including protecting consumers and competition from the incumbent LECs' incentives to abuse market power. Facilities-based entry into local markets continues to be very limited, and there can be no serious claim that the incumbent LECs' local market power has been eliminated by competition. Thus, there is no meaningful economic competition to justify repeal or modification of the Commission's regulatory accounting requirements under Section 11. And even if there were meaningful economic competition for local telecommunications services, that would not mean that repeal of any regulatory accounting requirements automatically is "necessary in the public interest." On the contrary, many of the purposes and benefits of regulatory accounting – such as implementing a universal service mechanism – are unrelated to the status of facilities-based competition.

maintain regulatory accounting requirements that can be used not just for federal purposes, but by the state commissions and by competitors.

II. THE COMMISSION SHOULD ADOPT THE RECOMMENDATIONS OF THE JOINT CONFERENCE TO REQUIRE ADDITIONAL AND DISAGGREGATED REGULATORY ACCOUNTING DATA, STRENGTHENED AFFILIATE TRANSACTION RULES, AND ADDITIONAL REPORTING REQUIREMENTS.

Recent accounting scandals and monopoly abuses have undermined public confidence in the telecommunications industry. Accordingly, shortly after the Chairman was appointed to the President's Corporate Fraud Task Force, the Commission convened the Federal-State Joint Conference on Accounting issues "to engage in a thorough analysis of the Commission's accounting requirements to ensure that regulatory accounting information is adequate and truthful and to ensure that information captured in the regulated accounts is both necessary and sufficient for regulatory purposes."[15] And, pending the Joint Conference's recommendations, the Commission suspended portions of its earlier *Phase II Order* and other orders, which had reflected the Commission's "prior efforts" that were heavily focused "on eliminating [accounting] reporting requirements."[16]

In its recommendations, the Joint Conference explained that, over the course of nearly a year (from October 17, 2002 to October 6, 2003), it re-examined the Commission's regulatory accounting and ARMIS reporting rules, as directed by the Commission.[17] After this thorough

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[15] Public Notice, *Federal-State Joint Conference on Accounting Issues Request for Comment*, 17 FCC Rcd. 24902, at 2 (2002).

[16] *Id*. The Commission extended the elimination of these accounting rules until January 1, 2004, a date that it recently extended to June 30, 2004. *See* Order, *Federal-State Joint Conference on Accounting Issues*, WC Docket No. 02-269, FCC 03-325 (rel. Dec. 23, 2003). If the Commission does not decide this matter by June 30, 2004, it should again extend the date on which it would eliminate the specified accounting rules.

[17] Letter from Members of Federal-State Joint Conference to Marlene Dortch, FCC, WC Docket No. 02-269 (Oct. 9, 2003).

review, the Joint Conference recommends that the Commission reconsider its previous decisions in the *Phase II Order* to eliminate many Part 32 accounts and to reduce ARMIS reporting requirements. *Joint Conf. Recommendation* at 2-3. Further, the Joint Conference recommends several modifications to those accounts and ARMIS reporting requirements. *Id.* at 8-20. The Joint Conference also re-examined the Commission's affiliate transaction rules, and recommends that the Commission refuse to implement certain changes proposed in the *Phase II Order* and to modify the rules to close loopholes in the existing rules. *Id.* at 21-31. Finally, the Joint Conference examined certain aspects of the Commission's reporting requirements, and it recommends that the Commission refuse to modify its rules as requested by the Bells. *Id* at 32-36.

A. The Commission Should Adopt The Joint Conference's Proposals To Modify Part 32 To Require Additional And Disaggregated Accounts.

There is no question that detailed regulatory accounting requirements are necessary to protect consumers and competition as the Commission implements and tests new deregulatory policies. The dominant incumbent LECs will use any small gap in those accounting requirements to hide patently anticompetitive conduct. Indeed, these LECs have defended their massive rates of return for special access services by arguing that the Commission's regulatory accounts for special access services are too aggregated to identify the exact cause of those colossal returns. The incumbents' response (although factually inaccurate) starkly confirms that detailed, disaggregated regulatory accounting data are critical to allow the Commission and states to fine-tune deregulation and other policies and to remove the incumbents' mainstay excuses for ignoring those accounts when they uncover market power abuses. As the telecommunications industry grows and changes, the information that should be contained in regulatory accounts will change. For now, the Commission should retain all existing regulatory accounting requirements, and adopt the proposed modifications recommended by the Joint Conference to expand certain specified accounts and to create new accounts for categories of costs and/or revenues that have recently grown in significance.

1. The Commission should reinstate Account 5230. In the *Phase II Order* (¶ 36), the Commission consolidated the miscellaneous revenue accounts (Accounts 5230 through 5270) into Account 5200, a generic "Miscellaneous Revenue" account. The Joint Conference properly recommends that the Commission should reinstate Account 5320 ("Directory Revenue"), which reflects revenues from the incumbents' directory services, such as publication of "yellow" and "white" pages. *Joint Conf. Recommendation* at 8-9. As the Joint Conference explains, it is critical to account for directory revenues separately from other accounts because those revenues come from a separate line of business that may be subject to different treatment by state commissions than other "miscellaneous" revenues. *Id.*; *Phase II Order* ¶ 36. If the Commission's consolidation of these accounts were to go into effect, the revenues from various services and lines of business (including "retail, corporate operations, customer operations and other incidental regulated revenue") will be "commingl[ed] . . . into one reported account." *Joint Conf. Recommendation* at 9. But, as the Joint Conference found, separate treatment of directory revenue is "necessary to the state regulators as they carry out the responsibility under the 1996 Act to protect consumers and competition against the incumbents' use of [their] local monopolies to gain a competitive advantage in the market for directory listings." *Id.*[18]

[18] *See also* Ohio CC and NASUCA Joint Comments, CC Docket No. 00-199, at 4 (filed July 26, 2001); AT&T *Ex Parte*, CC Docket No. 00-199, at 2 (filed Aug. 29, 2001). Section 254(k) imposes an independent, federal prohibition against cross-subsidization, but the regulatory accounting treatment proposed by the Joint Conference can be an essential tool to determine whether section 254(k) is being violated.

The only reason cited by the Commission for eliminating the separate Directory Listings account is that it was not "persuaded that there continues to be regulatory benefit from a federal perspective with maintaining directory revenue separately from miscellaneous revenue." *Phase II Order* ¶ 36. But as explained above, a federal benefit to retaining the data is *not* a necessary prerequisite for determining whether particular information should be included in the Commission's regulatory accounting requirements. On the contrary, as noted above, Congress clearly contemplated that the Commission – in developing its regulatory accounting requirements – would assess both federal *and* state needs for accounting information. *See, e.g.,* 47 U.S.C. § 220(i).

Given that the states have an articulated need for the Commission to collect these data separately, and that the Commission has explicitly recognized that the states' need for the data is legitimate, *Phase II Order* ¶ 36 ("[s]tate commenters have raised legitimate state concerns about retaining data on directory revenues separately"), the Commission should not have eliminated Account 5230.

2. Wholesale and retail subaccounts for Account 6620. In response to requests by state commissions, the Commission established "new subaccounts" that would require incumbent carriers "to separately record expenses associated with retail and wholesale services" for Accounts 6621-6623 (Call Completion Services (operator services); Number Services (directory assistance); and Customer Services), which the Commission consolidated into a single Account 6620 entitled "Services." *Phase II Order* ¶ 64. The Commission explained that the "wholesale versus retail distinction is important," that this distinction likely would "increase in importance as competition develops in the local exchange market," *id.*, and that "[a]dding these new subaccounts w[ould] assist the states in developing UNE rates that properly reflect the costs of providing a wholesale service." *Id.* The Commission also found that any burden associated with creating those accounts had not been quantified and, accordingly, did not outweigh the potential benefits. *Id.*

The Commission should retain the change in its rules requiring the ILECs to establish subaccounts that separately track retail versus wholesale expenses. As the Joint Conference confirms, distinct wholesale and resale accounts are important to assess the incumbent LECs' compliance with their duty "to offer for resale at wholesale rates any telecommunications service that the carrier provides at retail to subscribers." 47 U.S.C. § 251(c)(4); *see Joint Conf. Recommendation* at 14. As the Commission explained, "the per-line expenditure for customer service is higher at the retail level" in light of the fact that "CLECs (wholesale customers) do most of the customer functions themselves." *Phase II Order*, ¶ 64 & n.122. Thus, distinct wholesale and retail accounts plainly serve an important and current regulatory function.

Wholesale and retail accounts are important to states in UNE pricing proceedings. *See Joint Conf. Recommendation* at 14. Indeed, UNE prices reflect common costs, loading factors and other overhead costs attributable to the costs of operating a "wholesale" network. In assessing those costs, state commissions "routinely" look to the Bells' ARMIS accounts on the theory that historical ratios of such costs to investment may serve as a proxy (or at least a starting point) for estimating forward-looking levels of those costs. *Id.* As a result, the Commission's decision to require incumbent LECs to provide distinct subaccounts for retail and wholesale costs plainly "will assist states in developing UNE rates that properly reflect the costs of providing a wholesale service." *Phase II Order*, ¶ 64.

Moreover, the Commission has correctly noted – and the Joint Conference confirms – that the benefit of adding these subaccounts outweighs any potential burdens. While it is clear that the benefit of requiring a "wholesale/retail distinction will increase in importance as competition develops in the local exchange market" (*Phase II Order*, ¶ 64), no party has identified any particular burden associated with these reporting requirements. *Id.*; *see also Joint Conf. Recommendation* at 14-15 ("ILECs did not provide substantive evidence that it would be burdensome to provide a wholesale/retail breakdown" for Account 6623). Thus, the Commission correctly required that this information be reported, and should retain these accounts going forward.

The Joint Conference proposes instead to keep separate the 3 accounts regarding operator services, directory assistance, and customer services. *Id.* at 14-15. For the OS and DA accounts, no additional information would be reported. For the customer services account, the ARMIS rules would be modified to "require the reporting of the wholesale-retail percent" of customer services expense. *Id.* at 15. The ILECs would be required to provide the wholesale retail percent for each individual state, as "determined annually on a study basis ILECs already use in UNE proceedings." *Id.* Although the Joint Conference's approach may be feasible, there remains no basis for revisiting the Commission's approach adopted in the *Phase II Order*. It cannot be seriously disputed that subaccounts for all three categories will be beneficial to regulators and competitors. Even if the ILECs are not generally required to provide unbundled access to OS/DA services under federal law, *see Joint Conf. Recommendation* at 15, such requirements may still be required under state law. And, in all events, separate retail and wholesale subaccounts for OS/DA services will still be beneficial in establishing the resale discount even if OS/DA is not provided as an unbundled element. On the other hand, the Commission found that there would be little burden on the ILECs, and the Joint Conference agreed that the ILECs had not shown any burden in creating the separate subaccounts for customer services. *Id.* at 14-15.

3. Creation of New Accounts. As the Joint Conference recommends, the Commission should modify its Part 32 rules to add new accounts that would "incorporate significant changes in industry structure and regulation" and that would address "implementation of local competition and changing ILEC business models." *Id.* at 17. In particular, the Commission should supplement its current uniform system of accounts by requiring dominant carriers to report information relating to optical switching. *See id.* at 18. In the past, the Commission has declined to adopt new optical switching accounts on the ground that "adding the optical switching account is premature because the technology has not yet developed to the point where widespread deployment is imminent." *Phase II Order* ¶ 60. But the current level of deployment of optical switches is only one relevant factor when assessing whether to require dominant carriers to report such information, and other factors, as explained by the Joint Conference, militate strongly in favor of adding a separate optical switching account. *Joint Conf. Recommendation* at 18.

At the incumbents' urging, the Commission has determined that incumbents presumptively need not provide competitors with unbundled access to packet switching technology, including optical switching technology. *Triennial Review Order*, 18 FCC Rcd. 16978, ¶¶ 537-38 (2002). Because the incumbents and states often look to historical switched costs in estimating forward-looking costs for unbundled network elements, it is critical to ensure informed decisionmaking in these circumstances to maintain regulatory accounts that separate the costs of these various technologies so that the incumbents do not lump costs of new technologies in a way that could allow those costs to be included in the prices for network elements that are unbundled. Further, as the Joint Conference explains, state commissions would need such data when "determining universal service cost levels" and in "assess[ing] the extent to which the carriers are modernizing their networks in individual states." *Joint Conf. Recommendation* at 18. In addition, the benefits of a separate optical switching account plainly outweigh any potential burden. As the Joint Conference found, incumbents "presumably already keep track of this information, just as they do for non-optical switches" and, "to the extent that there are only a few optical switches deployed, collecting that information should not be overly burdensome." *Id.*

The Commission should also add a separate account for switching software to its uniform system of accounts, as the Joint Conference recommends. *Id.* at 18-19. In the *Phase II Order*, the Commission declined to add a separate account for switching software because it saw "no regulatory need at this time to separately track investment in switching software in a new subaccount." *Phase II Order* ¶ 62. However, as the Joint Conference explains, there is in fact a substantial regulatory need for a separate account for software investment. *Joint Conf. Recommendation* at 19. The incumbent LECs have, in state UNE rate proceedings, federal § 271 proceedings, and universal service cost model proceedings, begun to insist that existing and new switching software have had a significant impact on their switching costs.[19] The Joint Conference agreed with AT&T that "[t]he only way to determine whether these claims are legitimate, and to assess the impact of those costs on UNE rates and the universal service mechanism, is to require ILECs to maintain that information separately." *Joint Conf. Recommendation* at 19. The incumbent LECs have offered no legitimate reason why maintaining a separate switching software account would be unduly burdensome, and, judging by the incumbents' arguments in recent § 271 proceedings, they already maintain such

[19] *See, e.g.,* SBC California 271 Application, Reply Comments, Declaration of Richard L. Scholl, WC Docket No. 02-306, ¶¶ 19-23 (filed Nov. 4, 2002).

information. *Id.* Accordingly, the Commission should modify its Part 32 and ARMIS rules as recommended by the Joint Conference.

B. The Commission's Affiliate Transaction Rules Should Be Strengthened To Close Loopholes And To Ensure Disclosure Of All Transactions.

The Commission should not adopt the changes to its affiliate transaction rules contained in the *Phase 2 Order*, and instead should maintain and strengthen its existing affiliate transaction rules, as recommended by the Joint Conference. The need for such rules is even greater now that the Commission has begun to conduct biennial audits of the Bells pursuant to section 272. The first two section 272 audits – of Verizon in New York and of SBC in Texas – have uncovered substantial misconduct and violations of section 272.[20] On the basis of those audits, it is clear that the Commission should retain its affiliate transaction rules to ensure that it can effectively monitor and enforce both the statute and the Commission's rules.

1. Valuation of Affiliate Transactions. First, the Commission should adopt the Joint Conference's recommendation and reverse its decision in the *Phase II Order* (¶¶ 91-92) to provide incumbent LECs the discretion in valuing affiliate transactions. In the *Phase II Order*, the Commission permitted ILECs to use the higher or lower of cost or market valuation as either a floor or ceiling, depending on the direction of the transaction.[21] As the Joint Conference concludes, providing such discretion – for all transactions, regardless of the size – to dominant

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[20] *See Accounting Safeguards Under the Telecommunications Act*, CC Docket No. 96-150, Comments of AT&T Corp. on SBC's Section 272 Compliance Biennial Audit Report (filed Jan. 29, 2003); *Accounting Safeguards under the Telecommunications Act*, CC Docket No. 96-150, Comments of AT&T Corp. on Verizon's Section 272 Compliance Biennial Audit Report (filed April 8, 2002).

[21] *Phase II Order* ¶ 91 & n.172. As the Commission explained, "if the transaction were from the carrier to the nonregulated affiliate, the higher of cost or market valuation would function as the floor amount. . . . If the transaction were from the nonregulated affiliate to the carrier, the lower of cost or market valuation would function as the ceiling." *Id.*

local carriers with market power would provide "unrestrained" opportunities for cost misallocation and would "open[] the door to anti-competitive behavior." *Joint Conf. Recommendation* at 23. Given that the serious accounting problems in the telecommunications and other industries were often caused by affiliate transactions that were improperly recorded at prices that were out of line with the true market value of the assets and services transferred, the Commission plainly should be providing dominant carriers with less, not more, discretion in how to value affiliate transactions. *Id.* As the Joint Conference concludes, however, the Commission's rules provide nearly "unfettered discretion" for ILECs to "manipulat[e] costs, revenues, and earnings – precisely the type of problems that gave rise to this Joint Conference." *Id.*

The "touchstone of valuing [affiliate] transactions" must be the fair market value that would prevail in competitive markets. *See id.* But providing dominant carriers with discretion to value affiliate transactions allows the ILEC and its nonregulated affiliate to manipulate accounts and "to record a purchased asset or service at a very low value when, had the purchase been made in the open marketplace, the price would have been considerably higher. Such an under-valuation could result in prices that . . . are not cost-based." *Id.* It also can provide the ILEC's nonregulated affiliates with an unfair competitive advantage, because a "competitor could not arbitrarily choose the value to be recorded for a similar purchase." *Id.* For these reasons, the changes proposed in the *Phase II Order* should not be implemented.

2. *Prevailing Price Treatment Threshold.* The Commission also should adopt the Joint Conference's recommendation and refuse to decrease the threshold for external sales from 50% to 25% when determining the prevailing price under its affiliate transaction rules. *See* 47 C.F.R. § 32.27(d); *Phase II Order* ¶¶ 93-94; *Joint Conf. Recommendation* at 23-24.

Prevailing price valuation permits the ILECs to value sales of assets and services without regard to the fair market value, based solely on the price of that asset or service when sold to the general public. However, the Commission has concluded that prevailing price valuation cannot be used unless at least 50% of the sales of a particular asset or service are made to the general public. Otherwise, the ILEC could make the service nominally available to all, but in fact rig the offer so that it is unattractive to unaffiliated purchasers – thereby allowing the ILEC complete discretion in setting the transfer price without regard to true market value.

As the Joint Conference explains, there is no basis to reduce the threshold for external sales from 50% to just 25%, as the Commission determined in the *Phase II Order*. *See Joint Conf. Recommendation* at 24. There is no apparent burden from the existing rule.[22] Reducing the threshold could allow the ILECs, in multi-asset or multi-service deals, to "strategically underprice a relatively small amount of a particular service or asset to gain an offsetting concession" and "at the same time confer on its affiliate a competitive advantage" by virtue of the fact that the "ILEC would be absorbing some of the cost and thereby lowering the affiliate's cost structure." *Id.*

Further, the Commission should take additional steps to close off a significant loophole in its rules regarding prevailing price valuation. As it now stands, the Commission's rules exempt the Bells from the 50% external sales threshold for products and services subject to section 272

[22] Indeed, the Commission's *Phase II Order* is hardly a ringing endorsement for a rule change; the Commission stated only that "[w]e are skeptical that it is a sustainable strategy for a firm significantly to underprice transactions with 25 percent of its customers in order to be able to record transactions at that price with an affiliate," and that it would "monitor the situation to determine whether this modification has any unintended consequences." *Phase II Order* ¶ 94. In light of recent abuses, the Commission should retain the current rule, rather than take a leap of faith, monitor the situation, and hope for the best.

of the Act.[23] This is based on the view that § 272 requires that the Bells make such services available to unaffiliated carriers, and that the Bell-determined prevailing price will therefore in fact approximate market value. In fact, even if such services are nominally available, unaffiliated carriers may choose for legitimate business reasons not to purchase them – or the Bells may place terms and conditions on their services that make them unattractive to any carrier other than the Bells' § 272 affiliates. As a result, the Bells in fact have full discretion in setting the prevailing price even if § 272 applies. In these circumstances, the Bells will use that discretion in the anticompetitive manner described above, allowing the Bells (and their captive ratepayers) to bear the majority of the costs for jointly-provided services while the affiliate need only bear this small incremental cost but not any of the joint costs.[24]

This issue has significant competitive ramifications, because the Commission is considering allowing the Bells, for the first time, to jointly provide operating, installation, and maintenance (OI&M) services to the Bells' § 272 affiliates. Although that change would be unlawful and unwise for a host of reasons, it would be even more arbitrary for the Commission to allow the Bells to provide those services to the § 272 affiliate without also clearly prohibiting them from using the loophole in the prevailing price valuation to avoid the 50% external sales threshold. But Verizon has indicated it will do precisely that, which could enable it (and the other Bells) to allow its affiliate to record only the incremental cost of the additional time needed for Bell technicians to perform the OI&M services – even though no unaffiliated firm operating in the market would in fact provide OI&M services to the affiliate at the incremental cost. *See*

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[23] *See Accounting Safeguards Order* ¶ 137.

[24] *See* Declaration of Lee L. Selwyn, ¶¶ 27-32, WC Docket No. 03-228 (filed Dec. 10, 2003) (attached to Comments of AT&T) ("Selwyn Decl.").

Selwyn Decl. ¶¶ 27-33. The Commission should therefore retain the 50% external sales threshold and apply it to all affiliate transactions, including those involving section 272.

3. Intra-Holding Company Transfers. As recommended by the Joint Conference, the Commission should extend the scope of the affiliate transaction rules so that they apply to transactions between incumbent LECs that are owned by the same holding company in order to close a loophole that allows the Bells to game the system. *See Joint Conf. Recommendation* at 27. For example, if SBC-Pacific Bell sells services to SBC-SWBT, those transactions are entirely unregulated and unreported under the Commission's current rules, even though such transactions can result in inappropriate shifts in cost among entities within the same holding company. *Id.* Under the current rules, one ILEC can purchase services from another within the same holding company at inflated rates, and the purchasing ILEC will record that inflated rate as its expense in the relevant expense account (*e.g.*, engineering).[25] Such inflated transfer prices have no impact on the profits of the holding company, because the costs and revenues are merely being shifted from one pocket to another. By booking the inflated transaction as expenses, however, the purchasing ILEC can pass potentially inflated costs through to end-users in inflated end-user rates. *Joint Conf. Recommendation* at 27. Similarly, since virtually all TELRIC cost models use ARMIS reported data as inputs, these inflated transaction rates are also used to calculate UNE rates, which also become inflated. *Id.*

4. Affiliate Transactions and Section 272. The Joint Conference recommends that the Commission require the Bells, after the Commission decides to allow section 272 safeguards to sunset, to establish an affiliate that complies with the separation rules that now apply to

[25] This is no speculative concern: nearly 18 months ago, AT&T presented evidence showing that some Bells had created such affiliates and were engaged in such conduct. *See* Comments at AT&T, WC Docket No. 02-112, at 37-41 (filed August 5, 2002).

independent ILECs and to undergo biennial audits to test fully whether the Bell is engaged in cost misallocation or discriminatory behavior. *See id.* at 31 (citing 47 C.F.R. §§ 64.1901-1903). The Commission's *Notice* does not request comment on this issue, because it is purportedly being considered in a separate docket. *See Notice* ¶ 4 n.9. Nevertheless, two comments are appropriate: First, the Commission need not even consider the Joint Conference's proposal, because it should use the authority that Congress expressly provided to it to *extend* the section 272 safeguards until it is demonstrated that the Bell's market power has dissipated and it is no longer dominant. If the Commission properly applied the Act, consistent with its terms and the purposes of § 272, and extended the § 272 safeguards until this time, then it would be unnecessary to consider the safeguards that would apply after sunset, because by definition that would occur only after the Bells lost market power and had no ability to engage in discrimination or cost misallocation.

Second, when the Bells have advocated that the Commission allow the section 272 safeguards to sunset or to modify its rules implementing section 272, they have consistently pointed to the existence of other safeguards, including the Commission's cost allocation rules, as a safeguard that would continue to apply to protect against Bell misconduct.[26] As AT&T has explained, however, section 272 safeguards have unique benefits that the Commission's other safeguards lack and those safeguards should not now be eliminated.[27] But, regardless, the Bells' reliance on other accounting safeguards, including the affiliate transaction rules, to protect

[26] *See, e.g.*, Comments of the Verizon Tel. & Long Distance Companies at 12, WC Docket No. 03-228 (filed Dec. 10, 2003) (arguing that the Commission should eliminate rules implementing section 272(b)(1) because "the BOC also would have to comply with the accounting and pricing restrictions contained in the affiliate transaction rules. 47 C.F.R. § 32.27. This requirement would avoid misallocation of costs to BOC operations and would result in allocation of *all* relevant costs to the 272 affiliates") (emphasis added).

[27] *See, e.g.*, Reply Comments of AT&T at 20-23, WC Docket No. 02-112 (filed Aug. 26, 2002).

against the risks of Bell misconduct only highlights the essential need to revise, update, and strengthen the Commission's regulatory accounting and reporting rules so that they in fact "result in allocation of *all* relevant costs to the 272 affiliates," as Verizon admits is required.

C. The Incumbent LECs Should Be Required To Report Their Aggregated Fiber And DSL Deployment In Regulated Accounts.

As the Joint Conference recommends, the Commission should not reconsider its decision regarding the reporting of broadband infrastructure data in ARMIS reports. *Joint Conf. Recommendation* at 32-34. The Commission has emphasized that there "is an immediate and pressing need to assess the penetration of fiber in the local loop and gauge the development of broadband infrastructure." *Phase II Order* ¶ 175. Accordingly, to assess fiber deployment in the local loop, the Commission now requires the largest incumbent LECs to provide information showing the number of locations where interfaces between fiber and copper (or coaxial cable) exist, and the number of switched access lines that are physically routed through those locations, aggregated by study area, in ARMIS 43-07 Reports. *See id.* nn.332 & 333. Similarly, to measure broadband deployment over local telephone networks, the Commission now requires the largest incumbent LECs to provide the number of working digital subscriber lines ("DSL") terminated at customer premises locations, and the number of those lines that are provided through fiber/copper (or fiber/coaxial) interfaces, again aggregated by study area, in ARMIS 43-07 Reports.

The incumbent LECs have objected to providing this information in ARMIS 43-07 Reports because, they claim, fiber and DSL deployment information is confidential and, therefore, should not be made publicly available through those reports. Instead, they urge the Commission to collect fiber and DSL deployment information in Form 477, where the Commission has instituted procedures that streamline requests for confidentiality. For the reasons stated by the Joint Conference, this request should be rejected, and the Commission should retain its existing reporting requirements regarding broadband infrastructure data.

The predicate of the incumbents' argument – that the fiber and DSL deployment information to be provided in ARMIS 43-07 Reports warrants confidential treatment under the Commission's rules – is wrong. Confidential treatment is appropriate to protect data that would "assist[] competitors in preparing marketing strategies to use in direct competition with [the reporting carrier]."[28] But the ARMIS 43-07 data relating to fiber and DSL deployment will be collected and reported only at the "study area" level, *see Phase II Order* ¶ 158, and thus would not provide potential competitors with competitively sensitive information that could be used to compete against incumbent LECs. The incumbent LECs provide service throughout every service area, and data showing the number of fiber/copper interfaces or DSL lines terminated by an incumbent LEC at customer premises in that study area could not reveal broadband capabilities in any specific geographic area within the study area. But even if these data were found to be confidential, the incumbents' claim that these data would be subject to confidential treatment if reported on Form 477, but not if reported on the ARMIS 43-07 Report, is specious, because the mere fact that information is reported on Form 477 does not guarantee confidential treatment.[29]

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[28] *Southwestern Bell Telephone Company,* Tariff FCC No. 73, 11 FCC Rcd. 16418, ¶ 3 (1996). *See also Public Citizen Health Research Group* v. *FDA*, 185 F.3d 898, 905 (D.C. Cir. 1999).

[29] In this regard, the Commission's *Local Competition Report* is publicly filed but is derived from Form 477. With respect data reported on that Form, the Commission allows for a "streamlined" confidentiality request (by checking a box on Form 477). *See* Report and Order, *Local Competition and Broadband Reporting*, 15 FCC Rcd. 7717, ¶ 25 (2000). But simply checking that box does not automatically protect the data from disclosure. If a third party requests access to the data, the providing carrier must make a showing that the data fall within the Commission's confidentiality rules. The incumbent LECs, therefore, would have to demonstrate that their fiber and DSL deployment data fall within the Commission's confidentiality rules whether reported on Form 477 or provided in ARMIS 43-07 Reports.

Finally, shifting ILEC reporting of fiber and DSL deployment to Form 477 would impose substantial new burdens on all other LECs that meet the Form 477 reporting threshold. Only the largest incumbent LECs are required to submit ARMIS 43-07 Reports, *e.g,* Qwest, SBC, Verizon, and BellSouth. *See Phase II Order* ¶ 9. But *all* LECs that serve more than 10,000 or more voice-grade equivalent lines or 250 broadband lines would be subject to the new fiber and DSL fiber requirements if those reporting requirements are shifted from ARMIS 43-07 Reports to Form 477. Although the Commission has found that there are clear benefits to requiring the largest monopoly incumbent LECs – which serve the vast majority of lines – to report data relating to fiber and DSL investment, there has been no such showing that imposing such requirements on small and medium sized LECs would produce any measurable benefit. Thus, shifting fiber and DSL reporting requirements from Form 477 to ARMIS 43-07 Reports would appear to contravene the public interest.

CONCLUSION

For the foregoing reasons, the Commission should retain and extend its regulatory accounting requirements as discussed above.

Respectfully submitted,

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January 30, 2004

CERTIFICATE OF SERVICE

I hereby certify that on this 30th day of January, 2004, I caused true and correct copies of the forgoing Comments of AT&T Corp. to be served on all parties by mailing, postage prepaid to their addresses listed on the attached service list.

Dated: January 30, 2004
Washington, D.C.

/s/ Peter M. Andros

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